FAST FOOD FRANCHISING:
THE BETTER WAY?

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TABLE OF CONTENTS

LIST OF TABLES

CHAPTER I

INTRODUCTION

The great majority of franchisors offer an opportunity for making the ambitious dreams of thousands of Americans come true. The modern business franchise has touched off a revolution in the traditional patterns of American marketing and, without question, it is here to stay. Harry Kursh[1] has called this phenomenon the "franchise boom," and franchising has been touted as the "odds-on favorite"[2] for the small businessman. The extent and intensity of the boom has not been accurately measured, nor have the odds for success been raised to near certainty; however, it is clear that the franchised system of operation and particularly the modern service sponsor-retailer franchise, has provided unlimited opportunity for many, with a relatively limited initial investment of capital.

Yet not all franchisees have been successful. The recent financial difficulties of a major franchisor, with its more than 200 outlets,[3] was a blow to the industry. This type

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[1]Harry Kursh, <u>The Franchise Boom</u> (New Rev. ed; Englewood Cliffs, N. J.: Prentice-Hall, Inc., 1968), p. v.

[2]J. F. Atkinson, <u>Franchising: The Odds-On Favorite</u> (Chicago: International Franchise Association, 1968), p. 34.

[3]Performance Systems, Inc., franchisor of Minnie Pearl food outlets reported a 1969 deficit of $30.8 million and a $5.5 million loss on revenue of $15 million for the first half of 1970.

of failure is all but unheard of in the industry, and was probably due for the most part to general economic conditions rather than gross mismanagement on the part of the company, but failures of individual franchisees are not uncommon. According to Dun and Bradstreet, franchising has an impressively low failure rate of less than 1 per cent.[1] One author surveyed the records of a large group of reputable franchising companies and reported that the highest failure rate he was able to find was 4 per cent and that some had no failures at all.[2]

Franchisors, in essence, are selling success. When a franchise completely fails, and the failure becomes public knowledge, the man who held the franchise is blamed. The franchising industry as a whole, including the inferior and dishonest companies, has a failure rate, proven by experience, of much less than 10 per cent of all franchises.[3] This figure is higher than that given earlier as computed by Dun and Bradstreet, but it is likely that not all companies were considered in the Dun and Bradstreet figure. Generally, it can be conceded that the failure rate in franchising is low.

In contrast to the relatively low failure rates quoted for franchised businesses, recent U. S. Department of Commerce figures show that 30 per cent of businesses started

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[1]David B. Slater, "Some Socio-Economic Footnotes on Franchising," Business Review-Boston University, XI (Summer, 1964), p. 8 (Reprint).

[2]Kursh, op. cit., p. 49.

[3]Slater, op. cit., p. 7.

by individuals fail in the first year.[1] Another source cites an overall failure rate for small business of approximately 60 per cent.[2]

Since statistical data indicate that there is, in the aggregate at least, a better chance of success in small business if the business is an element of a franchise system, then this difference must be caused by elements contained in the franchise system of operation, or conversely, by elements not present in comparable independent small businesses.

Statement of the Primary and Subsidiary Questions

The primary question addressed here is: *Do the relationships, management services and controls in modern fast food franchising provide an element of stability to the franchisee's operation which is likely to enhance its chance of success?*

To form a basis for answering this question, it is necessary to determine the meaning of "success." *Webster's New World Dictionary* defines "success" as "a favorable or satisfactory outcome or result"[3] What is favorable or satisfactory to one businessman may be considered unfavorable or unsatisfactory to a second businessman and beyond the wildest

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[1]Alan Keller, "Small Business Dream Has a Large Future," *New York World-Telegram*, March 16, 1965, p. 1.

[2]J. A. H. Curry, *et. al.*, *Partners For Profit: A Study of Franchising* (New York: American Management Association, Inc., 1966), p. 94.

[3]*Webster's New World Dictionary* (College Edition, 1962), p. 1455.

dreams of a third. It must be recognized that success cannot be measured in absolute values, but the author considers it reasonable to define the elements of success in a franchised operation as: (1) a good chance of staying in business, (2) a potential for growth, (3) a livable income which is in proportion to effort expended and the amount of capital invested, and (4) a lasting opportunity for interesting work.

In considering the primary question, certain subsidiary questions come to mind. In order for a distribution system to survive in a competitive and inventive society such as ours, there must be reasons, real or imagined, for its acceptance, continuation and growth. What is the history of franchising in the United States? What were the causes for its development and the reasons for its rapid growth? What is the size and scope of the franchising industry in America today?

Answers to the above questions will serve to justify the existence of the franchise system as an economic force and as an acceptable method of marketing and distribution from the point of view of the franchisor. But additional questions must be posed and answered to form a sound base of factual information in support of an answer to the primary question. These have to do with the other half of the relationship, the franchisee. Without his support the most inventive, most aggressive, most highly organized franchisor would fail in short order. What are the elements and relationships in

a typical fast food service franchised operation? What are the potential advantages to the franchisee in a franchise relationship? What are the potential disadvantages? Do the advantages outweigh the disadvantages, at least in his mind? Answers to these questions will round out the data base. The primary question can then be answered.

Purpose and Scope of the Study

The general purpose of this study is to provide more information about franchising as a system of distribution and management by investigating certain aspects of the system, with emphasis on the management services and controls provided by the franchisor and their utilization by and worth to the franchisee. Within this framework particular attention will be devoted to the service sponsor-retailer category of franchised operation, specifically the fast food franchise. The study is restricted geographically to representative operations in the area of the Nation's Capital, including its Northern Virginia suburbs. The ultimate purpose is to make judgment on the effect of the factors investigated on the potential success of individual franchise operations. This in turn will serve as partial proof or as evidence for disclaimer of the optimistic claims set forth in the literature by proponents of the system, especially the franchisors.

Utility of the Study

While the subject area was chosen primarily to satisfy

the curiosity of the author, it has become evident that most of the research material in the field of franchising is of an extremely general nature with a preponderance of "how to" books.[1] It is, for the most part, strongly pro or con. Numerous claims are made by proponents of franchising who stress the virtues of the system. Such claims often leave the reader with little idea as to the extent advantages of the system are realized and under what conditions they most often prevail. The con side is most often presented as a general indictment of franchising, with little or no discussion of advantages. It is important that reference material be developed which fairly presents both the advantages and disadvantages of the system.

Secondly, there will continue to be a large number of individuals who need more information before accepting the position of franchisee. This would seem to be true not only for the novice but also for the individual who has been successful as an independent businessman and who faces the choice of remaining independent or pursuing the "advantages" of the franchised operation. Most current sources of information

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[1]Cf. Robert H. Perry and Whitt N. Schultz, How to Start, Build and Operate Your Own Franchise Business (Chicago: Perry & Schultz, Publishers, 1962); Harry Gross and Robert S. Levy, A Guide to Franchise Investigation and Contract Negotiation (New York: Pilot Industries, Inc., 1967); Daniel J. Scherer, Financial Security and Independence through a Small Business Franchise (Rev. ed.; New York: Pilot Industries, Inc., 1967); Samuel Small, Starting a Business After 50, (New York: Pilot Industries, Inc., 1967).

focus on the needs of the novice.

A third reason for the study concerns itself with the information needs of the franchisor. Since the franchisor depends on his franchisees as the central object in his effort to achieve a type of vertical integration, it behooves him to strengthen the relationship through the use of adequate information. There are definite indications that many franchisors have not realized the potentials that a franchise system can afford.[1]

Finally, there seems to be relatively few studies that have dealt specifically with management and control aspects of franchising despite significant growth in this area. The general opinion of those knowledgeable of franchising seems to be that considerably more research and analysis is needed. Franchising is not only a method of distribution, for it has in addition the potential of a viable system of management. While more study of all aspects of franchising is needed as indicated earlier, the management potential seems to stand out as one of the more important. Considerable effort has been put forth toward developing methods for providing management assistance to small businessmen. The extent to which franchising actually provides such management assistance is still open to further investigation. This is not to say that increased

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[1]S. Michal Ingraham, "Management Control Potentials and Practices of Franchise Systems" (Unpublished Ph. D. dissertation, University of California, Los Angeles, 1963), p. 216.

attention to research in management in franchising is totally lacking. One example of growing concern is the recent formation, for the purpose of promoting research and seminars to improve efforts in franchising, of the Center for the Study of Franchise Management at Boston College.[1]

Definition of Terms and Concepts of Franchising

Franchise System.--The word franchise has a variety of meanings; however, when referring to economic activity it is generally thought of in one of two general categories as illustrated by the definition found in the *Dictionary of Economics and Business*.

> (1) A right granted by a government to a corporation, firm, or individual to carry on a certain kind of business in a certain place. Public utilities, such as railroads and trolley companies, operate under franchises. (2) By analogy, a similar grant by a manufacturer to a distributor with respect to products.[2]

The latter reference to a relationship or grant involving two private firms rather than the government and another party is more applicable to the study at hand, but far from adequate.

An accepted marketing definition would generally refer to the franchise relationship as "any contract under

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[1]David B. Slater and Charles L. Vaughn, eds. *Franchising Today* (Boston: Boston College Press, 1965), p. 89.

[2]Cornelius Janzen and Erwin Nemmers, *Dictionary of Economics and Business* (Patterson, N. J.: Littlefield, Adams & Co., 1960), p. 124.

which independent retailers or wholesalers are organized to act in concert with each other or with manufacturers to distribute given products or services."[1] While this definition identifies the three types of firms which are involved in franchise systems and gives some indication of the different types of structures that can be employed, it does not refer to the management aspect which has recently become popular. The International Franchise Association, however, puts forth very positively the idea of management assistance as part of the relationship. They refer to franchising as "a continuing relationship in which a franchisor provides a licensed privilege to do business, plus assistance in organizing, training, merchandising and management, in return for a consideration from the franchisee."[2]

As a result of the assistance provided, the franchisor will generally require features that allow for some control of franchisees. The authors of The Franchise System of Distribution offer a definition that includes both the purpose and the scope of such features.

> In an effort to maintain a highly standardized image and approach to the general public, many franchisors will utilize some formalized system of control. The control

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[1]Leonard Knops, "What is Meant by Franchise Selling?" Journal of Marketing, April, 1963, p. 37.

[2]Official Franchise Opportunity Handbook (Chicago: International Franchise Association, 1970), p. 4.

system will usually be concerned with both qualitative and quantitative aspects of the business.[1]

The type of franchised systems referred to in this study generally includes both the assistance and control features with the result being a type of "chain" operation utilizing a common trade name. However, to avoid confusion, it must be pointed out that many manufacturers use franchise agreements that promote selective or exclusive channels of distribution, but that have very limited control and assistance features and do not require franchisees to use a particular name for their firms. One example would be an electrical appliance manufacturer who allows an independent retailer to handle his products. In many cases like this the franchisee is known as an "authorized dealer." It is often found that a dealer of this kind will have franchise contracts or understandings with several manufacturers while the name of his firm reflects none of them in particular.

With some idea of the various features that can be employed in a franchise system, brief attention will be given to basic types in existence. William P. Hall, writing in the Harvard Business Review, set up four categories of franchise systems in existence today.

The first and probably most traditional type is the manufacturer-retailer franchise. "In this category, manufacturers may franchise (a) the entire outlet, (b) a single

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[1]Robert S. Hancock and Edwin H. Lewis, The Franchise System of Distribution (Minneapolis: The University of Minnesota Press, 1963), p. 8.

department, or (c) a line within a department in particular retail outlets."[1] Examples would include oil companies and automobile producers where an entire outlet is franchised, soft-goods manufacturers who franchise departments, and radio and television producers who are concerned with franchising a line of products.

A second category of franchising is the manufacturer-wholesaler, exemplified by the soft-drink industry. Large national cola producers who manufacture syrups franchise independent bottlers who in turn wholesale to retail outlets.

The wholesaler-retailer is a third type that is found prominently in both food and drug distribution. An example would be a cooperative arrangement where retailers join together to buy and operate a wholesaling organization. The organization then acts as a franchisor in setting standards and providing the wholesale function. Another variation results from a privately owned wholesaler who signs up independent retailers on a voluntary basis. The Independent Grocers Alliance (IGA) and the Walgreen Company are cases in point.

The fourth and most recent type of franchising is what Hall calls the service sponsor-retailer. Within this category the typical system involves a franchisor offering a franchise which consists of some service type operation. The United

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[1] William P. Hall, "Franchising--New Scope For an Old Technique," Harvard Business Review, January-February, 1964, pp. 62-63.

States Department of Commerce lists thirty-five categories[1] in this type of franchising. Examples include fast food service operations, motels and hotels, auto rental agencies, and employment contractors. The franchisee is nearly always a service type retailer, and assistance and control features are dominant in this category, with the purpose of improving the success factor for both the franchisor and the franchisee.

It is with the service sponsor-retailer type franchise that this study is concerned. Thus, taking into consideration the structure and purpose involved in that category, the following definition is set forth for purposes of this study; A franchise system consists of service type retail outlets resulting from a contractual agreement with a supplier who, through assistance and control, attempts to expand the marketing of his service and/or product.

According to current thinking, the elements of franchising do qualify as a bonafide system. The authors of The Theory and Management of Systems define a system as "an array of components designed to accomplish a particular objective."[2] They point out that a system relies on an objective, an established arrangement, and a plan for allocating inputs. The franchising system meets these criteria.

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[1] U. S., Department of Commerce, Business and Defense Services Administration, Franchise Company Data for Equal Opportunity in Business (Washington, D. C.: Business and Defense Services Administration, 1970), pp. iii-iv.

[2] Richard Johnson, Fremont Kast, and James Rosenzweig, The Theory and Management of Systems (New York: McGraw-Hill Book Company, Inc., 1963), p. 91.

Franchisee.--The owner of the retail outlet in a franchise system is known as the franchisee. The franchisee may organize as a sole proprietorship, a partnership or a corporation, and in the legal sense is independent. However, in the sense that the firm is franchised, it owes its name and right to handle a certain product or service to another firm who acts as franchisor. In this context, the franchisee can be called the licensee or contract holder. The retail outlet owned or leased by the franchisee will from time to time be referred to as the franchised firm or franchised operation.

Franchisor.--The franchisor is the supplier in a franchise system and exists as a separate legal entity from the franchisee. The franchisor may be in the business of supplying products, assistance, an accepted trade name, a format or way of doing business, or any combination of these things. As a supplier, the franchisor may be dependent on franchisees for a part or all of its distribution at the retail level. Many franchisors have company owned and operated retail outlets as well as franchised operations. It is well to remember that the interdependence of the franchisor and his franchisees is a most important factor in the maintenance of a franchise system. The franchisor is sometimes called the licensor or parent firm when referring to the franchise relationship.

Nonfranchise firm.--The term nonfranchise firm will be used in this study to refer to firms that are not members of a franchise system. Since most such firms are independent in the full sense of the word, they will also be referred to as independents.

Fast food service operations.--These establishments are defined, for the purposes of this study, as roadside or business complex establishments that provide prepared food on order and utilize limited dining facilities, curb service, carry out, delivery service or any combination of these customer accomodation tools. The term does not include such operations as full-service restaurants or firms specializing in extremely limited product ranges such as donuts or ice cream, even though they may sell a wide variety of types or flavors of these limited products.

Approach to the Study

This study has been approached with a view toward examining the historical basis for and the elements of management assistance and control in the franchisee-franchisor relationship. Through search of the literature the author has attempted to define and understand those elements and to present them in a precise and logical manner, taking care to present the pros and cons for both the franchisor and the franchisee. Citation of prior works, articles and papers

is utilized to the extent considered necessary to lend credibility to the arrangement of the material. This approach has been used to the greatest extent in the study of the history, development and growth of the franchising industry.

In addition to searching the literature for trends in services and controls and for differences observed by others in their ranges of applicability, interpretation and acceptance among franchisors and franchisees, the author has tested the literature by personal observation of franchised operations and by interviewing owners and managers of several of them in the Washington Metropolitan area and Northern Virginia suburbs. While a structured interview was not used, it is considered that the information gathered from these observations and interviews provided a valid test. Observations of non-franchised firms' operations, and interviews with their owners and managers as well as with officials of franchisor firms served as control mechanisms in analysis of the primary and secondary data. The names of firms and people interviewed are left unstated in the study in deference to the attitudes of openness and trust exhibited by those interviewed and to protect the confidences that they disclosed.

Organization of the Study

Chapter II discusses the historical and developmental aspects of franchising, with particular emphasis on the reasons

behind its emergence as a marketing and distribution method which gained rapid acceptance by those entering the system as franchisors. Chapter III examines the system from the point of view of the franchisee, examining the potential advantages and limitations of franchising to the small businessman. The elements of the relationship are established in the format of a description of a typical franchised operation, and primary data is utilized to test the validity of the elements described in the literature. The last chapter draws on the facts and impressions set down in the preceding chapters to provide a summary of the findings and to present conclusions in the context of the scope of the primary and secondary questions.

CHAPTER II

HISTORY AND GROWTH OF THE FRANCHISING INDUSTRY

Introduction

It would seem inappropriate to compare franchised firms with other franchised firms and with their independent competitors without first examining the background factors surrounding a franchise system. The purpose of Chapter II is to deal with the history, growth and present status of franchise systems. The chapter will examine the reasons for the growth of the system and will comment on its present size and impact on the economy. It will be noted that the service sponsor-retailer is an adaptation of earlier developed franchise systems such as those used in the oil and automobile industries.

Development of Franchising

A semblance of modern business franchising can be traced back to a period preceeding the twentieth century. For example, companies would endow wagon peddlers with exclusive rights to sell products in assigned areas, with the assurance that no other peddler would be permitted to purchase and sell the same products in those areas.[1] While other arrangements

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[1]Kursh, op. cit., p. 5.

of this type, now known as the service sponsor-retailer system, may have existed along the way, the first widespread use of the method came after World War II. Other systems of franchising did appear and flourish, however, early in the twentieth century.

The petroleum industry provides a good example of the development of franchise activity, along with the rationale involved. While the term franchising was not generally used to describe the activities which brought about integration in the final stages of petroleum marketing, the dealer-operated or lease-and-license programs were in substance and structure equivalent to franchise systems of a general nature.

Forward integration by refiners gained speed after 1911 when the automobile market created a need for new distribution facilities. The result was the development of drive-in service stations which were aimed at providing higher standards of services and taking advantage of the profit potential which existed at the retail level. The development of dealer lease-and-license programs came later, in a period from 1920 to about 1935, when refiners were interested in increasing the number of assured outlets and expanding into new territories.[1] Dealer programs gained further momentum in the late 1930's and soon flourished industrywide. A number of reasons have been put forth as to why this movement

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[1]John G. McLean and Robert Wm. Haigh, The Growth of Integrated Oil Companies (Boston: Division of Research, Graduate School of Business Administration, Harvard University, 1954), p. 287.

took place at that time.

> Company owned and operated service stations were leased to dealers because the stations were suffering serious losses in volume to other types of outlets and because the owners believed that the lease arrangements would permit a reduction in distribution costs. The company owned and operated stations were suffering losses in volume chiefly because their prices were not competitive with those of other marketers and because it was not easy to make quick adjustments in the prices at such stations to meet individual market situations. The factors tending to make the company operation of stations more expensive in many situations than a contractor or dealer type of operation were chain store taxes, wage and hour laws, the Social Security Act, the unionization of service station employees, and the difficulty of adjusting the working hours of salaried employees to the requirements of the service stations' business.[1]

The oil industry continues to use franchise programs today as a part of its total distribution system.

Very early in the twentieth century most passenger cars were sold on a consignment basis to dealers operating at the retail level.[2] Since that time however, the automobile industry has used three different channels of distribution at various times. "The first of these is manufacturer-distributor-retailer-consumer. The second is manufacturer-manufacturer's own branch, wherein retail and wholesale operations are combined. The third is manufacturer-retailer-dealer through the manufacturer's own sales organization."[3] All of these channels of distribution have been reduced greatly in importance

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[1]*Ibid*., p. 301.

[2]Charles N. Davidson, "Automobiles," in *Marketing Channels for Manufactured Products*, ed. by Richard M. Clewett (Homewood, Ill.: Richard D. Irwin, Inc., 1954), p. 92.

[3]*Ibid*., p. 83.

as the manufacturer to franchised dealer-salesman channel has emerged as the primary method of automobile distribution.

The basic reasons for the attractiveness of franchised dealers from the standpoint of the automobile manufacturer have been set forth by Charles Hewitt, Jr.[1] He indicates that exclusive franchise territories attracted a high-grade and financially stronger dealer while at the same time allowed better production planning since sales were limited to one dealer per area. Similar reasoning was applied to the protection of the retail price structure and reduced selling costs since fewer customers (dealers) were involved. By giving dealers sufficient volume, the manufacturer could require that only his make was sold, thus eliminating the possibility of a divided selling effort. Finally, by having a limited number of dealers, the manufacturer could attain better control at the retail level through the use of a franchise contract. Investment in up-to-date outlets capable of providing adequate service after the sale can be required.

The automobile industry thus provides a second example of the development of franchise systems. Along with the oil industry, it is also representative of the manufacturer-retailer type franchise system mentioned in Chapter I.

Early developments in franchising were not limited to the petroleum and automobile industries. Indeed, some

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[1]Charles Mason Hewitt, Jr., Automobile Franchise Agreements (Homewood, Ill.: Richard D. Irwin, Inc., 1956), pp. 55-56.

of the most striking success stories in the franchising industry prior to World War II occurred in the food, drug, and auto supply lines. In 1902 Louis K. Liggett, a twenty-seven-year-old druggist, launched a franchising system which has had notable results. Started as a cooperative, his idea developed into the world renowned "Rexall" franchise system. During the early thirties The Western Auto Supply Company started its franchising plan which now includes over four thousand franchised outlets, and in 1927 Ben Franklin variety stores, a division of Butler Brothers, began its franchising chain which is now nationwide.[1]

Franchising also gained impetus from the development of aggressive chain stores in the 1920's. Many independents were ill equipped to counter the offers of such chains and to save their businesses moved to affiliate themselves with wholesalers.[2] These in turn developed into wholesaler-retailer type franchise systems which were characterized by food store owners joining together to set up a common wholesale organization.

Most observers point to the period following World War II as the one containing the most notable expansion in the use of franchising. According to one source, "Franchising

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[1]Kursh, op. cit., pp. 5-6.

[2]Franchising: The Modern Channel of Distribution (Chicago: International Franchise Association, n. d.),pp.3-4

experienced a boom in the late 1950's that carried over into the 1960's."[1] The return of millions of servicemen with money saved, the abundance of new products, the availability to individuals of plenty of government money on credit, and the lack of corporate capital available for extensive expansion were the major forces which caused this growth in franchising. Military personnel returning from the war were extremely ambitious and had ample borrowing power to obtain business loans guaranteed or insured by the Veteran's Administration. The idea of being one's own boss expressed their feelings perfectly.[2] Kursh cites a second factor in the post-World War II franchise expansion: "a booming economy, which inspired executives with business ideas to cash in through franchising."[3] The service sponsor-retailer franchise system appears to have thrived on these factors and as a result has become prominent since the war.

Growth of the Franchising Industry

Dr. S. Michal Ingraham sets forth three appropriate classes of reasons dealing with the current existence and growth of post-war franchising industry. He divides contributing

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[1] H. N. Broom and Justin G. Longenecker, Small Business Management (2nd ed.; Chicago: South-Western Publishing Company, 1966), pp. 549-550.

[2] A. J. Vogl, "Franchising: The New American Dream," Sales Management, May 15, 1964, p. 90.

[3] Kursh, op. cit., p. 6.

factors into primary, facilitative, and derivative reasons.[1] Primary reasons are those which act as basic motivations for a firm to choose franchising rather than some other system of distribution; facilitative reasons are based on a set of conditions in the economy that allow franchising to develop; and derivative reasons are those that result from a successful franchise system once in existence.[2] In all three cases these reasons are primarily concerned with the franchisor, since he is most often in the position of initiating a franchise system.

Primary reasons.--Primary reasons first include the nature and demands of the product or service handled by a firm. For example, a product must generally be differentiated in either a real or psychological sense to qualify for franchising.[3] Obviously an automobile represents such a product differentiation that can demand certain customer response and, in turn, the desire of a franchisee to remain part of a franchise system. On the other hand, the products of those firms included in the study were more limited in their degree of differentiation. As a result, the franchisor was in a position of promoting such factors as trade name, building design, or a "franchise package" which represented

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[1] Ingraham, op. cit., pp. 56-94.

[2] Ibid., pp. 47-48.

[3] Ibid., p. 57.

a unique way of doing business that was desirable to franchisees and customers alike.[1] Whatever the product, the franchisor generally attempts to intensify selling efforts by capitalizing on product differentiation.

In the case of a new product, franchising appeals to a producer since it presents an alternative to traditional channels of distribution which might provide only limited selling effort for introducing new items. This was particularly true following World War II when many new products were competing for the use of existing channels.[2] Producers of older, established products, on the other hand, may turn to franchising as a way of overcoming a slow growth rate due in part to the way the item has been marketed. A good example of this is a franchised muffler shop which specializes in the installation and sale of one brand of mufflers only. This type of operation is aimed at giving the proper product differentiation and selling effort needed.

A second primary reason contributing to the existence of franchising deals with the financial needs of franchisors. Since most firms are interested in growth and expansion, the need for increased financial resources is always present, and in the case of a small business, often intensified by limited capital sources. Franchising presents a possible alternative whereby expansion in marketing and in turn

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[1]Hancock and Lewis, op. cit., p. 68.

[2]Ingraham, op. cit., p. 58.

production can be attained with less investment capital than would be required if a firm owned and operated all of its outlets. Also, expansion can take place at a faster rate, since the franchisee puts up the initial capital plus paying off any debt that may be required. There are countless firms that have become nationally known in a relatively short period of time due in large part to their successful use of franchising. For example, Kentucky Fried Chicken started business a scant 16 years ago, and in 1970 boasted 2700 outlets, of which 2200 were franchised operations.[1] The total value of the shares outstanding in the Louisville-based fast food restaurant and inn operator in March, 1971 was near $285 million.[2] Another example is Holiday Inns of America, Inc., which incorporated in 1954 and now has an enviable record of expansion. "Its 72,000 rooms are more than Hilton Hotels Corporation and Howard Johnson's Motor Lodges, Inc., combined. Its sales which multiplied almost 12 times in one six-year period, approach $60 million annually."[3] These are just two examples of the large number of franchise systems, especially the service sponsor-retailer

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[1]"Food Franchises 1970!" <u>Franchise Journal</u>, July, 1970, p. 40.

[2]"Kentucky Fried, Heublein Reach Merger Accord," <u>Wall Street Journal</u>, March 10, 1971, p. 1.

[3]Richard Martin, "Holiday Inns of America, Inc., Helping Franchisers," <u>How They Sell</u> (New York: Dow Jones & Co., 1965), p. 192.

type, that have experienced significant growth in recent years. Table 1 provides representative examples of the age, size and anticipated growth of firms engaged in fast food franchising.

Franchising also has a financial advantage in developing market coverage in areas of limited sales potential. For example, Western Auto Supply Company has both company-owned and franchised retail outlets which handle automotive accessories, hardware, household appliances and sporting goods. The company follows a policy of granting franchises for stores in the smaller cities where profit requirements are often less for franchisees as opposed to company owned stores. The latter are used for larger cities where they can be preperly justified on the basis of profit potential.[1]

Ingraham's study, which was based on the analysis of 17 franchisors, provides further indication as to the financial advantages of franchising. He concluded in the following way:

> The inference to be drawn from the foregoing is not that franchising is a means of expansion without funds required by the franchisor, however. It is, rather, that far less funds are necessary than if the franchisor were to attempt to establish company owned outlets.[2]

A third primary reason is concerned with those managerial aspects of franchising that cause the management of a firm to initiate a franchise system rather than some

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[1]Ingraham, op. cit., p. 64, citing Modern Franchising, March-April, 1961, p. 24.

[2]Ibid., p. 74.

TABLE 1

GROWTH OF FAST FOOD FRANCHISING

FRANCHISOR	YEARS IN FRANCHISING	FRANCHISES OPERATING-1969	EST. UNITS BY 1971	EST. UNITS BY 1976
Arby's Roast Beef	5	328	600	--
A & W International	50	2360	2435	--
Barnaby's Inc.	2	9	135	340
Burger King Corp.	12	554	720	--
Chicken Delight	18	481	550	670
Dairy Queen	8	3942	4000	--
Der Wienerschnitzel	6	222	260	410
Dog n Suds Inc.	17	500	580	--
Hardee's Food Sys.	9	120	365	715
International House of Pancakes	11	250	360	--
Kentucky Fried Chicken	15	2200	2650	--
Md. Fried Chicken	5	99	145	300
Pasquale's Pizza	8	119	265	500
Roy Rogers	3	153	315	840
Taco Bell	5	376	435	--
Three Chefs	1	6	15	50
Tony Bennett's	1	1	35	240
Whataburger Drive-Inns	16	60	85	--

Note: Data in Table 1 reflects end of calendar year 1969 figures.

Source: "Food Franchises 1970!" Franchise Journal, July, pp. 32-49.

other alternative. For example, if company owned outlets are desired, a firm often experiences difficulty in acquiring competent managers to take charge of the newly created units. Moreover, when the outlets are small, the problem is further intensified by the lack of incentives on the part of hired managers. Franchisees, on the other hand, are most often inspired by the fact that they have both a personal and a financial investment in the outlet.

The opportunities of gaining independence and increasing one's income tend to be strong motivating factors in the United States.[1] "Some men (i. e. franchisors) satisfy this drive by organizing entirely new businesses, while others (i. e. franchisees) are more content to accept a sound business proposition which affords financial rewards and a degree of independence."[2] As a result of the latter, there tends to be an abundant supply of franchisees, further enhancing the desirability of franchising.

Facilitative reasons.--In addition to the primary reasons dealing with product, financial, and managerial aspects, there are several facilitative reasons for the current expansion of franchising. As mentioned earlier, facilitative reasons are those factors or circumstances that are conducive to the existence of franchising in the economy.

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[1] Hancock and Lewis, op. cit., p. 68.

[2] Ibid., p. 17.

Dr. David L. Huff, in a speech at a seminar meeting of the International Franchise Association, stated factors that in his view have provided the greatest impetus to the rise in franchising:

1. The vast increase in the number as well as variety of goods produced;

2. The continuing trend toward urbanization;

3. The rise in spendable income;

4. The increase in automobile ownership; and

5. The development and availability of high-speed computers.[1]

In reference to the first reason cited, many retailers have had to reduce the effort and time devoted to the sale of any one product in recent years due to a rapidly increasing number of competing items. Obviously, supermarkets and drug stores are good examples of this situation. The result has been that many producers have turned to franchising as a method of gaining the sales effort they feel is necessary in today's competition between new products.

The second, third and fourth reasons mentioned are all outgrowths of an expanding economy and population. Urbanization provides concentrated markets for new franchisees while at the same time permitting better control by the franchisor due to the smaller area involved. The rise in spendable income has resulted in increased discretionary buying of specialty and luxury products along with service,

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[1]Ingraham, op. cit., p. 86., citing "Growth Prospects of Franchising," an article based upon the speech by Dr. Huff, Modern Franchising, January - February, 1961, p. 9.

all of which are characteristic of the offerings of franchised firms. An illustration of American spending habits is contained in statistics attributed to the Institute of Food Service Manufacturers Association. "In 1968, over thirty billion dollars were spent by the American public in 'away from home eating places' and they are expected to reach about fifty billion dollars by 1975."[1] While not all of these sales are attributable to foods from franchised businesses, a clear indication for their further growth is evident. The increase in automobile ownership in connection with the movement to suburbia has created circumstances favorable to all types of drive-in operations, ranging from franchised cleaning establishments to food and beverage outlets.[2] Indications are that these three developments will continue to be important factors in the expansion of franchising.

The development and availability of computers allows a franchisor the possibility of improving control over the entire franchise system. He can also provide accounting services to franchisees which in turn improve the over-all franchise package. These possibilities represent one way in which a small businessman (i. e. a franchisee) can be introduced to computer applications. The same holds true for many other innovations and changes that require adaptation.

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[1]"The Franchise Newsfront," Franchise Journal, January, 1971, p. 30.

[2]"Franchise to Growth," Financial World, September 8, 1965, p. 5.

One additional facilitative reason not appearing in the list prepared by Dr. Huff deals with the expanding demand for service in our economy.[1] "The last half century has seen the base of American employment and production change from farming to manufacturing. Today the change is from manufacturing, from industry, to services."[2] Moreover, service is, of course, harder to standardize and tends to require more variation to meet local needs. This then facilitates franchising and especially the service sponsor-retailer type franchise, since the franchisee in most systems is allowed some flexibility while meeting the demand for service in a unified fashion.

Derivative reasons.--While primary and facilitative reasons tend to be more prominent, there are in addition two derivative reasons for the expansion of franchising since the war. These are factors which have resulted as "by-products" of a successful franchise system operated by a management cognizant of existing potentials. In other words, if a franchise system is managed correctly it may realize the "derivative" benefits of product diversification and increased market value of the system itself.[3]

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[1]Stan Misunas, ed., The 1970 Franchise Annual (Chicago: National Franchise Reports, 1970), p. 3.

[2]John Toigo, "Consumer Profiles, Potentials and Buying Habits," Modern Franchising, June - July 1966, p. 13.

[3]Ingraham, op. cit., p. 91.

Product diversification can result when a franchisor expands his product line to take advantage of the additional demands of his franchisees. For example, a franchisor may sell only one basic product when a franchise system is initiated; however, as time passes he may add other items which he feels can be sold to franchisees. Many of the franchisees contacted in the study indicated that franchisors had indeed expanded their product and service lines. Some also felt they were required to buy items at a higher price from the franchisor than that charged by other suppliers outside the system. In any case, product diversification is a distinct possibility for the franchisor.

The increased market value of the franchise system can result as a second derivative benefit with the expansion of demand based on proven methods at the retail level. If initial franchised outlets are greatly successful, it is highly probable that an increased demand for that type of franchise will result. Since the supply of new franchises of the type is generally limited by the need to protect existing franchisees, market value will increase. This phenomenon, of course, parallels basic economic supply and demand theory, and its applicability was verified by several franchisees contacted.

Franchising Today

Most observers readily agree that franchising has

reached a position of being recognized as a potent system of distribution and management.[1] However, when one attempts to determine the extent to which it represents a part of total marketing activity, the lack of any valid statistics presents a real barrier. While several estimates of franchise impact have been made, none of them are readily accepted as being authentic. This situation has led the Board of Governors of the Center for the Study of Franchise Distribution at Boston College to consider the development of year-to-year statistics reflecting objective estimates of the status of franchising. If and when this will be adopted is not known.[2] There is a need for meaningful statistics, but few are available some five years after the pronouncement. Concern for the inadequate statistical information on franchising was recently expressed by the Select Committee on Small Business of the United States Senate. Based on hearings in the first half of 1970, the Committee estimated that there were approximately 600,000 franchisees responsible for upwards of $100 billion in sales annually.[3] Since this accounts for one-tenth of our trillion dollar Gross National

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[1]Cf. Misunas, op. cit., p. 10; Hancock and Lewis, op. cit., p. 10.

[2]National Franchise Reports, May, 1966, p. 1.

[3]U. S., Congress, Senate, Select Committee on Small Business, Impact of Franchising on Small Business, S. Rept. 91-1344, 91st Cong., 2d sess. (Washington, D. C.: Government Printing Office, 1970), p.2.

Product, it is no wonder that descriptions of the growth of franchising have been couched in superlatives.

Summary

Chapter II has been based on a large volume of secondary data along with information gained by the author's own investigation to present a review of some of the essential factors surrounding the service sponsor-retailer franchise system, particularly its development and growth. Among the factors discussed was the history of franchising, Franchising was used early in this century by both the automobile and petroleum industries and later by many other industries. The service sponsor-retailer type realized most of its growth following World War II. Of the many reasons for this growth, factors relating to the nature of the product, need for financing, and managerial considerations were paramount, essentially as they related to development of the industry from the point of view of the franchisor. An idea of the present status of franchising is gained by examination of estimates of the number of franchised firms and the dollar sales they represent, recognizing that there has been a lack of meaningful statistics on the size and scope of the franchising industry.

CHAPTER III

PROS AND CONS IN FRANCHISING

Introduction

Chapter III will lead off with a descriptive example of a franchise relationship, as the basis for a discussion dealing with the potential advantages and limitations of a franchise system. Since this section of the study deals with the real world aspects of franchising, it is here that the comments of franchisors, franchisees and independents contacted in the course of the study will be interjected to support or disclaim the positions stated in the literature. Recent legislative efforts in franchising will also be dealt with in this chapter, particularly as they apply to the limitations discussed.

The Typical Franchise

In order to understand more completely the service sponsor-retailer system which is continually referred to herein, the following brief description is presented as being representative of those franchised fast food service operations common to the industry.

Objectives.--According to the definition stated in Chapter I, the primary objective of a franchise system is to expand the marketing of the franchisor's service and/or product. The franchisor may have other varied objectives, but the above is most comprehensive when thinking in terms of the entire system. The individual objectives of the franchisees vary, and it thus becomes the job of the parent firm to bring about cooperation. Most of the fast food service franchisees contacted appeared to be willing to cooperate in a general way with their respective franchisors.

The retail outlet.--In general, most franchised fast food service operations rely on the motoring public for a great portion of their business. A limited, low-cost menu featuring various sandwiches and short orders is generally used so that fast food service is available to the customer. Methods of food preparation and customer service are often standardized, thus allowing extensive use of both nonskilled and part-time workers. While both female and male employees are hired, those firms contacted used young men to a predominate degree. The managers indicated that males were more readily available and best suited for the type of work involved.

Many franchised fast food service operations operate on a self-service basis with the customer dining in his automobile while parked on the premises. Others provide

limited dining facilities which allow space for customers to be seated after they have obtained their food from a self-service window. Still others use a combination of these two methods.

Franchisor policies and controls.--The working relationship that exists between the franchisor and the franchisee is generally based on a detailed franchise contract. Such a contract is drawn up by the franchisor and includes those items he feels are essential for both his protection and the success of the franchisee. Of central importance is the amount of capital which the franchisee is expected to provide for equipment and building. The franchisee is also normally expected to provide for his own working capital requirements. Table 2 presents typical capital requirements.

Another financial consideration concerns fees and royalties paid to the franchisor. These are not asset related; rather they represent the price of the privilege of using the franchisor's name and methods. There may be an initial fee plus continuing charges usually computed as a percentage of gross sales of from two to fourteen per cent.[1]

Most contracts include provisions that give the franchisee protection against the franchisor putting several franchisees in a limited area. Such a provision is usually specified in terms of a geographic area containing a certain amount of population, thus allowing sufficient potential

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[1]"Franchising," Small Business Reporter, Vol.9, No.9, p. 5.

TABLE 2

CAPITAL REQUIREMENTS FOR FAST FOOD FRANCHISES
(Money amounts in thousands of dollars)

FRANCHISOR	TOTAL COST	INITIAL CASH	INCLUDES OPERATING CAPITAL
Arby's Roast Beef	70.0 - 75.0	35.0	YES
A & W International	5.0 - 12.5	9.0 - 24.5	YES
Barnaby's Inc.	100.0	45.0	YES
Burger King Corp.	80.0	45.0	YES
Chicken Delight	19.7	19.7	--
Dairy Queen	52.0	17.5	YES
Der Wienerschnitzel	5.0 - 15.0	5.0	NO
Dog n Suds Inc.	--	20.0	YES
Hardee's Food Sys.	--	40.0	YES
International House of Pancakes	55.0	25.0	NO
Kentucky Fried Chicken	44.6	23.6	YES
Md. Fried Chicken	28.5	21.5	NO
Pasquale's Pizza	12.0	6.0	NO
Roy Rogers	--	40.0	YES
Taco Bell	24.0	5.0	NO
Three Chefs	--	30.0	YES
Tony Bennett's	60.0	20.0	NO
Whataburger Drive-Inns	--	25.0	YES

Source: "Food Franchises 1970!" Franchise Journal, July, pp. 32-49.

for all franchisees.

The franchisor generally reserves the right to participate in the selection of a location for the franchisee. Also, he will require that certain building plans be followed so that all franchisees have a similar appearing structure which the customer can identify as a trademark. Most franchised fast food service operations provide considerable parking space and have both a brightly painted building and a large lighted sign to attract the customers' attention. In some cases the franchisor may construct the building and give the franchisee a long term lease with renewal options.

Also in the contract, one may find performance controls which require the franchisee to operate in a prescribed manner. Examples include cleanliness standards for the preparation and handling of food, standards for portion control and recipes to be used, and control over purchases. With regard to the latter, the franchisee may be required to buy equipment, certain foods, and paper products from the franchisor. If items are purchased from outside sources, the franchisor may specify the quality that must be used.

The franchisee is usually limited in the number of products he may offer for sale. He is also asked to participate in large promotional activities at the regional and national level; however, this may be on a voluntary basis. With regard to pricing policy, the franchisor usually suggests a price

or a certain range to follow.

In case either party may wish to bring an end to the contractual relationship, provisions are included for termination or transfer of the franchise. A method of determining the value of assets is often included to avoid conflict in case of termination. When the franchisee wishes to sell the franchise, he must obtain approval of the prospective buyer from the franchisor. Under certain conditions the franchisor may buy the operation and run it as a company owned outlet until a suitable franchisee is located.

<u>Services provided by the franchisor</u>.--The franchisee expects to receive certain services from the franchisor as a result of the relationship, particularly if he is expected to pay a high initial franchise fee and/or considerable annual fixed charges or sales based royalties. The extent and quality of services provided by the franchisor run the gamut from nearly nothing to a "turn-key" operation consisting of a facility with equipment, supplies, inventories, personnel, systems and procedures, set up by the franchisor and ready for operation by the franchisee upon his completion of the company training program. Follow-on services also vary among franchisors, but usually include the furnishing of a basic accounting system which may include periodic audit and evaluation and income tax preparation by the franchisor, periodic assistance and inspection visits by franchisor

representatives, and an open telephone line for discussion of operating problems. Negotiation of volume contracts with purveyors and suppliers is often used so the franchisee can receive the benefits of high quality and low prices. Also, and usually at extra cost, franchisor-prepared national, regional and local advertising and help with local promotions may be furnished.

Other franchisor-furnished services often include considerable financial assistance, particularly in the initial establishment of the franchised operation and sometimes in the form of continuing operating credit. Also, marketing research conducted by the franchisor can be of great importance to the franchisee, since few of his independent competitors have such information available to them. Product and service development are also distinct possibilities that relate to the research effort on the part of the franchisor. Not the least of the types of franchisor assistance, but also widely variable between franchisors, is the initial training program. Usually offered at the franchisor's headquarters or at a company owned outlet, this program is often conducted in a manner which thoroughly tests the potential franchisee's ability to operate his business. To some franchisors, satisfactory completion of the training is a prerequisite to acceptance of the franchisee and execution of the franchise agreement or contract.

In general the franchisor may well act as a clearing house of information which provides the franchisee with ideas on many different topics. Such information can be the basis for the franchisee to prepare for the initial operation of a franchised business and to adapt to the inevitable changes that will take place as the business matures.

Potential Advantages to the Franchisee

The discussion in Chapter II which centered on the reasons for the growth of franchising related primarily to the franchisor. To balance the scale it is necessary to discuss the potential advantages that are stressed for the franchisee as the result of a successful franchise system.

First, and of primary significance to the study at hand, is the often mentioned advantage of management guidance which is offered the franchisee as a result of his relationship with the franchisor.

> The management ability of franchisees . . . should be substantially strengthened by the franchisor's experiences. The better recruiting programs, the training programs, and the franchise package offered by the experienced franchisor are all designed to improve the management efficiency with the system.[1]

Statements similar to that of Hancock and Lewis can be found in many different sources when a discussion of the advantages of franchising is set forth.[2] In general, most writers feel

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[1]Hancock and Lewis, op. cit., p. 89.

[2]Cf. Slater and Vaughn, op. cit., p. 3; Broom and Longenecker, op. cit., p. 550.

that management assistance, which consists of many different things as mentioned earlier in connection with the discussion of the typical franchise system, is a significant advantage to the franchisee. It is, of course, in part the purpose of this study to test the reaction of operating franchisees as to the extent to which this advantage is realized.

A second and very basic advantage is the possibility of greater stability and survival on the part of the franchisee in the long run, as contrasted to the potential for success of his independent competitor. Implicit in this statement is assumption of the profit motive and its appeal to the franchisee. It has been estimated that the failure rate for franchised firms is 10 per cent as compared with approximately 50 per cent for independents who start on their own.[1] As mentioned previously, there is a notable absence of meaningful statistics on franchising. J. F. Atkinson's study is perhaps the most meaningful statistical comparison available. He concludes, "Even if the actual franchise failure rate were eight times greater than reported, it would still pay an investor to be franchised rather than start an independent small business!"[2] This would indicate an even higher independent to franchisee failure ratio than found by Buckley. If such estimates can be relied upon, the franchise system

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[1]Noel Buckley, "Fortunes in Franchising," Dun's Review & Modern Industry, April, 1964, p. 82.

[2]Atkinson, op. cit., p. 19.

certainly provides an advantage in reduced risk and higher survival potential.

Related to the profit potential is a third advantage which emphasizes the extension of an established name and reputation to the franchisee. If the franchise system is large and has a good reputation, this intangible is immediately available to the franchisee. Motorists away from home are likely to patronize an establishment with a familiar name, particularly if they have received satisfaction with the product or service offered by their local franchisee operating under the same name. A variation on this theme is the more recent establishment of franchised operations carrying the names of celebrities. While a reputation for satisfactory product or service must be established to enjoy repeat business, the "good guy" image of the celebrity is an initial drawing card. An appearance at grand openings by the celebrity, common in this arrangement, also gives the franchisee an initial promotional boost. In contrast, an independent may have to spend many years to develop an equivalent image and status.

A fourth advantage to the franchisee centers around the idea that the position affords an individual a degree of independence that one could not ordinarily attain while being an employee.[1] While nonfranchise firms would in most cases have a greater degree of discretion, franchising offers

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[1] Official Franchise Opportunity Handbook, op. cit., p. 5.

a compromise that appeals to the strong desire for independence on the part of individuals within the United States.

Fifth, the franchise system facilitates the rendering of upgraded service to the customer. "The operating standards of franchise businesses not only govern each outlet, they are also generally higher than standards adopted by most small-business owners."[1] Franchising, by promoting higher standards, thus has the potential of assisting the franchisee in the attainment of the service objective.

Finally, a group of advantages related closely to the others mentioned concern the provision of physical services to the franchisee, allowing him to concentrate his efforts on the operational and profit-making aspects of his business. The independent businessman must engage in considerable planning and make a large number of decisions, often at considerable expense for expert consultive services, in the initial establishment of his business. These may include site selection, market research, building design, equipment selection and layout, interior decorating, sign design, menu selection, and many decisions on printing services for on site placards and initial direct mail and media advertising. Most of these decisions are not one-time, but continue throughout the life of the business. These types of decisions are generally made for the franchisee, and are often actually imposed on him throughout the term

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[1]Hancock and Lewis, op. cit., p. 87.

of the franchise relationship. While they may be considered a dilution of the aforementioned advantage of independence, they should certainly be mentioned as advantages to the franchisee, particularly as they affect his ability to concentrate his time and energy on the physical production of saleable products or services.

All of the franchisees contacted in the study indicated that they felt that their franchise arrangement afforded them advantages that they could not otherwise get. The advantage that was most often mentioned was that of having the established name and reputation of the franchisor and a distinctive building and equipment package. The advantage of management and operating assistance, including franchisor furnished promotional material and advertising, was generally considered the second most important. Other advantages frequently mentioned were franchisor furnished (and sometimes maintained) accounting systems, and the advantage of obtaining cost reductions through centralized purchases initiated by the franchisor.

Potential Limitations of the Franchise System

It would be erroneous to assume that franchise systems are without limitations. Like other alternatives, the service sponsor-retailer franchise could hardly be considered a panacea for all types of distribution and related management problems. The system does have possible limitations from the standpoint

of the franchisee.

When social and economic innovations are tried for the first time they are often accompanied by a fringe group whose actions border on acceptability with regard to both legal statute and good taste. Franchising, being no exception, has been plagued by a minority that deals fraudulently in attracting prospective franchisees. A Senate Committee recently concluded that dishonest and unscrupulous practices have been employed by a segment of the franchising industry, that many instances of franchise failures of small businessmen could be traced directly to slick, well-written, highly illusory advertisements in respected national financial newspapers or trade journals, and that there had been franchise advertising and sales abuses in direct mail materials and high pressure sales tactics.[1] In the course of the hearings, Chief Postal Inspector William J. Cotter informed the committee: "During the past 5 years, we have investigated 612 cases of this general type (franchise frauds) which in total have occasioned the loss of over $27 million to investors."[2] Since this averages out to approximately $44,117 per case, it is no small potential disadvantage to the franchisee. In a 1965 report, the National Better Business Bureau listed franchising fraud as being an often used method to take advantage of

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[1] U. S. Congress, Senate, Select Committee on Small Business, op. cit., p. 2.

[2] Ibid., p. 12.

unsuspecting individuals.[1]

An article by John F. Lyons in The Wall Street Journal referred to an example where a stevedore invested in a franchise only to find later that the assets he received from the franchisor were worth about 10 per cent of the price he paid. The franchisor obviously could not be found when this fact was realized.[2] Similar articles have appeared in other newspapers and periodicals indicating that the individual considering the role of a franchisee must face the task of trying to obtain reliable information.

A second limitation sometimes encountered by the franchisee results from restrictions and limitations placed on his actions by the franchisor. While the degree of independence was earlier mentioned as an advantage to the franchisee, there are situations where it may be seriously hampered. Vigorously enforced contract provisions may limit the discretionary action of the franchisee and thus reduce his aspirations.[3] Moreover, such restrictions may reduce the franchisee's flexibility to use his own ideas and his adaptability in a changing local situation. Kursh recognizes this limitation as one of the major ones facing prospective

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[1]"The Top Ten Consumer Schemes in the U. S.," Spotlight on Schemes, National Better Business Bureau, December, 1965, p. 4.

[2]John F. Lyons, "Franchising Risks," Wall Street Journal, April 6, 1966, p. 1.

[3]Broom and Longenecker, op. cit., pp. 550-551.

franchisees: "The parent company may end up having so much control over you that they could dictate policies and practices injurious to you but not to others in the chain, for the sake of invoking the principle of the greatest good for the greatest number."[1] In effect, inflexibility imposed by the franchisor through his insistance on certain policies contrary to the franchisee's local situation may reduce his profit potential rather than enhancing it as intended.

Another area of possible concern for the franchisee is the legal aspect of franchising in the United States today. Basically, the legal aspects that confront the franchisee can be grouped into two categories. First, the franchisee has to be aware of those legal situations that may result in a termination of his franchising agreement; and secondly, he is concerned with laws, court decisions and regulatory agency rulings that affect the status of the entire franchise relationship. The latter is most generally associated with the franchisor, but nevertheless has a bearing on the franchisee.

The conditions that lead to the termination of a franchise arrangement are generally specified by the franchisor in the franchise contract. In some cases this places the franchisee in a position of being subject to an implicit threat of cancellation by the franchisor if certain conditions are not met. This type of threat "has been extensively reviewed in Congressional hearings, Federal Trade Commission

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[1]Kursh, op. cit., p. 45.

reports, and economic treatises."[1] One result of such investigation has been the enactment of the Automobile Dealers Franchise Act of 1956. The act is aimed at strengthening the position of automobile franchisees in their relationships with the large manufacturers. Popularly called the "day in court" act, it permits the automobile dealer to bring suit in a Federal district court against a manufacturer if the manufacturer did not "act in good faith . . . in terminating, canceling, or in renewing the franchise . . ."[2] The dealer has the burden of showing a lack of good faith; consequently, most suits brought under this act by dealers against manufacturers have been unsuccessful. Senator Phillip A. Hart, Chairman of the Subcommittee on Antitrust and Monopoly of the Committee of the Judiciary, contends that it is questionable whether the act has had any significant effect on the economic power held by the franchisor.[3]

As a result of the general dissatisfaction with the Automobile Dealers Franchise Act because of its ineffectiveness and particularly because it did not extend to other

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[1]Lewis B. Schwartz, Free Enterprise and Economic Organization (2d ed.; Brooklyn, N. Y.: The Foundation Press, Inc., 1959), p. 472.

[2]Automobile Dealers Franchise Act, U. S. Code secs. 1221-1225 (1956).

[3]U. S., Congress, Senate, Committee on the Judiciary, Distribution Problems Affecting Small Business: Part 2, Hearings before the Subcommittee on Antitrust and Monopoly, 89th Cong., 1st sess., Pursuant to S. Res. 191., January 18-27, 1966 (Washington, D. C.: Government Printing Office, 1966), pp. 696-697.

industries, several bills[1] have been introduced recently in the U. S. Congress designed to remedy the defects in the act and to protect franchisees against arbitrary and unreasonable termination of the franchise agreement by the franchisor. However, passage of reforms in this area seems unlikely during the present session of Congress.[2]

The legality of the entire franchise method of doing business, which was mentioned earlier as the second legal consideration for the franchisee, has been of considerable interest to Congress, the Federal Trade Commission, and the Department of Justice, Historically the legal status of franchising has been based on the axiom that a seller has the right to limit the number of firms he sells to and to protect the good will of his product through reasonable restrictions placed on the buyer (franchisee). The extent to which franchisors restrict the number of buyers within a certain territory is measured in terms of the rule of reason, "since it does not fall within recognized categories of per sa violations."[3] However, territorial restrictions

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[1]See H. R. 13628, 91st Cong., 1st sess. (1969); H. R. 12490, 91st Cong., 1st sess. (1969); S. 1967, 91st Cong., 1st sess. (1969); H. R. 2818, 90th Cong., 1st sess. (1967), S. 2507, 90th Cong., 1st sess. (1967); S. 2321, 90th Cong., 1st sess. (1967); H. R. 11972, 89th Cong., 2d sess. (1966); H. R. 10113, 89th Cong., 1st sess. (1965).

[2]U. S., Congress, Senate, Select Committee on Small Business, op. cit., p. 25.

[3]Schwartz, op. cit., p. 471.

have been under intensive study by the Antitrust Division of the Department of Justice.[1] The Department strongly opposed enactment of a bill that would keep territorial restrictions, taken alone, from being held illegal. In hearings regarding this possible legislation, Assistant Attorney General Donald F. Turner summarized as follows:

> In sum, while vertically imposed territorial restrictions may sometimes be justified as procompetitive, the circumstances under which they are justified seem to us to be few and far between. Most of the time such restrictions cannot be justified and may cause considerable economic harm.[2]

In order to be more specific about what is actually considered legal, Mr. Robert Hammond of the Antitrust Division of the Department of Justice stated that his division was in the process of devising guidelines as to the application of antitrust laws to franchising.[3] However, a spokesman in the Antitrust Division was unable to verify the existence of such guidelines in March, 1971. Insight as to the legal status of franchising can also be gained from the many court

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[1] National Franchise Reports, June, 1967. p. 10.

[2] U. S., Congress, Senate, Committee on the Judiciary, Distribution Problems Affecting Small Business: Part 3, Hearings before the Subcommittee on Antitrust and Monopoly, 89th Cong., 1st sess., Pursuant to S. 2549., June 21-27, 1966 (Washington, D. C.: Government Printing Office, 1966), p. 1089.

[3] Robert A. Hammond, "Franchising Tomorrow," (text of an address before the Second Annual Conference on Franchising, Boston College, Chestnut Hill, Mass., April 13, 1966), p. 1. (Mimeographed).

decisions in the area. Harry L. Rudnick, legal counsel for the International Franchise Association, has made many comments on such court decisions and has analyzed them in relation to their significance to franchise contracts.[1] Both of the above are symptoms of the questioning on the part of individuals regarding the legal status of franchising.

Despite this questioning, there seems to be indications that the service sponsor-retailer type franchise system has evoked some favorable response on the part of various governmental departments. Eugene P. Foley, administrator for the Small Business Administration, made the following statement before a United States Senate hearing.

> Franchising chains are an alternative - - and evidently a highly promising one - - to centrally owned chains. Now the evidence is clear that the chain is, on the whole, a valuable and productive form of economic organization. It generates economies in purchasing, in advertising, and spreads valuable and expensive management techniques and know-how over a broad base.[2]

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[1]Harry L. Rudnick, "Text of Remarks before the Second Arrowhead Conference on Franchising, April 25-28, 1965, Lake Arrowhead California," (University of California Extention and the International Franchise Association), (Booklet).

[2]U. S., Congress, Senate, Committee on the Judiciary, Distribution Problems Affecting Small Business: Part 1, Hearings before the Subcommittee on Antitrust and Monopoly, 89th Cong., 1st sess., Pursuant to S. Res. 40., March 2-4, 1965 (Washington, D. C.: Government Printing Office, 1965), p. 7.

Continuing enthusiasm on the part of the Small Business Administration was evidenced at the more recent Senate hearings when W. Donald Brewer, Deputy Administrator, told the subcommittee:

> Franchising benefits both the businessman in rural America and the minority businessman in urban areas. At the present time, both groups are facing increasing competition from the chain and other large businesses. . . . For members of minority groups and for those in rural America who are now deprived of the opportunity to own their own business, franchising may well be their last shining opportunity, their port of last hope.[1]

Charles Bangert, assistant counsel, United States Senate Judiciary Committee also expressed his feelings that franchising has a position in the United States economy based on his reading of Senator Hart's opinion. He states: "I think that Senator Hart, who is Chairman of the Senate Anti-trust and Monopoly Sub-committee, is very sympathetic to this way of doing business."[2]

A fourth limitation of franchising deals with the problem of selecting new franchisees to add to an already successful system. The addition of new franchisees that do not uphold standards can have a damaging effect on goodwill that has been created by earlier members of a

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[1]U. S., Congress, Senate, Select Committee on Small Business, op. cit., p. 11.

[2]Charles Bangert, "Comments on the Antitrust Laws and Franchising," Franchising Today, David B. Slater and Charles L. Vaughn, eds., (Boston: Boston College Press, 1965), p. 89.

successful franchise system. While often contrary to the franchisor's desires, it is sometimes very difficult to screen out the poor franchisee prospects.[1] Kursh assesses this potential disadvantage by quoting David B. Slater, Mr. Donut's former president, who put the point succinctly: "A weak cup of coffee served in one shop can lose a customer of the others; a day-old donut served as fresh reflects badly on the management of all. The customer does not view the shop he patronizes as one entity; if he is dissatisfied, he is apt to blame the chain."[2] Close attention to selection of new franchisees can minimize this problem for existing ones.

When the franchisees contacted in the study were asked if they felt there were shortcomings in their franchise relationship, nearly two-thirds answered in the affirmative. Most of the limitations mentioned dealt with operating conditions which they felt the franchisor had failed to properly perform. The more prominent examples were lack of assistance by the franchisor, too many restrictions in the franchise contract, and slow and infrequent communications with the franchisor. Only one individual indicated that legal considerations created problems for his franchise arrangement.

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[1]Hancock and Lewis, op. cit., p. 80.

[2]Kursh, op. cit., p. 46.

Summary

The typical franchise arrangement consists of many requirements and provisions on both the part of the franchisor and the franchisee. The franchisee hopes to realize such advantages as management guidance, greater independence, stability of operation, an established name and reputation and better service for his customers. However, on the other hand, he must be aware of potential limitations such as fraud, loss of discretionary action, legal problems, and the selection of additional franchisees who may not maintain the standards of the system. All franchisees contacted by the author recognized advantages in the relationship, and most of them felt that certain limitations affected them personally; but, without exception, they indicated that the advantages far outweighed the disadvantages or limitations.

CHAPTER IV

SUMMARY AND CONCLUSIONS

The foregoing discussion gives some insight into a comparatively new and generally successful form of distribution and marketing, the service sponsor-retailer type of franchised operation. The purpose of this study was to provide an answer to the primary research question: Do the relationships, management services and controls in modern fast food franchising provide an element of stability to the franchisee's operation which is likely to enhance its chance of success? Research of primary and secondary sources has clearly supported an answer in the affirmative. The franchisee is more likely to be successful than his independent competitor, and his superior chance of success can, to a large extent, be directly attributed to the relationships, management services and controls in the franchise arrangement.

In answering the primary question, several subsidiary questions were considered: What is the history of franchising in the United States? What were the causes for its development and the reasons for its rapid growth? What is the size and

scope of the franchising industry in America today? What are the elements and relationships in a typical fast food service franchised operation? What are the potential advantages to the franchisee in a franchise relationship? What are the potential disadvantages? Do the advantages outweigh the disadvantages, at least in his own mind? Chapters II and III provided an in-depth analysis of these questions. The following paragraphs provide a summary of the research to answer the subsidiary questions.

The service sponsor-retailer type of franchised operation can be traced back to a period preceeding the twentieth century, but it did not gain wide acceptance until after World War II. Prior to the emergence of the service sponsor-retailer type as a major franchising factor, the automobile manufacturers and petroleum companies practiced franchising primarily as a means of forward integration. Recognizing the need to provide higher standards of service and taking advantage of the profit potential which existed at the retail level, the petroleum industry converted to dealer-operated or lease-and-license programs until by the late 1930's the practice was prevalent industry-wide. The automobile industry followed suit in a parallel time frame, abandoning its practice of selling automobiles on a consignment basis to dealers operating at the retail level. Both of these systems were and still are representative of the manu-

facturer-retailer type of franchise system.

Other developments in the franchising industry prior to World War II were generally concentrated in the food, drug and auto supply lines, with successful use of the method evidenced by such firms as "Rexall," The Western Auto Supply Company, Ben Franklin variety stores and the Independent Grocers Alliance (IGA) food stores. These operations grew out of the concept of lower pricing through cooperatives, and were in many cases last stand efforts by independents to compete with the growing number of "chain" operations. Called wholesaler-retailer type franchises, many of these companies continue to enjoy success today, as do manufacturer-wholesaler type franchises exemplified by the soft-drink industry.

There were several reasons for the emergence of the service sponsor-retailer franchise after World War II. Prominent among these was the return of millions of service-men with money saved and strong desire to be "independent" after taking orders for several years, the abundance of new products, the availability to individuals of plenty of government money on credit, and the lack of corporate capital available for extensive expansion.

. Once the service sponsor-retailer type franchise relationship emerged, a complex set of reasons went into play

to precipitate its rapid growth. Primary reasons, or basic motivations for a firm to choose franchising as a system of distribution, include product differentiation that can demand certain customer response, opportunity to provide a "franchise package" which represented a unique way of doing business that was desirable to franchisees and customers alike, the appeal of a new distribution channel as an alternative to clogged existing distribution channels and as a way of overcoming a slow growth rate, financial considerations such as the opportunity for expansion in marketing and in turn production with less investment capital than would be required if a firm owned and operated all of its own outlets, and managerial aspects, particularly the relative ease of attracting managers that have both a personal and a financial investment in an outlet over managers salaried by the firms.

Facilitative reasons, or those circumstances that are conducive to existence of franchising in the economy, include the vast increase in the number as well as variety of goods produced, the continuing trend toward urbanization, the rise in spendable income, the increase in automobile ownership, the development and availability of high speed computers, and the expanding demand for service in our economy. In connection with this last facilitative reason, it was noted that the first half of the twentieth century had seen the base of American employment and production change from

farming to manufacture, and that the change since then was from manufacturing to service.

A third set of reasons for the rapid growth of modern franchising was termed derivative factors, or "by-products" of a successful franchise system operated by a management cognizant of existing potentials. Though not as prominent as primary and facilitative reasons, two derivative reasons stand out: product diversification and increased market value of the system itself. The former deals with expansion of the product line to take advantage of the additional demands of the franchisees and of the retail customers of the franchisee, while the latter is based on the concept of supply and demand relationships. If initial franchised outlets are greatly successful, it is highly probable that an increased demand for that type of franchise will result and that prospective franchisees will be willing to pay more money for the privilege of doing business under the name of a successful firm than did the early franchisees.

All of these reasons have contributed to a currently mammoth franchising industry. While meaningful statistics are lacking, it has been estimated that franchising is a $100 billion industry, consisting of some 600,000 franchised outlets.

The typical franchise is based on a franchisor-franchisee relationship founded on a consistency of goals

and objectives, primarily that of expanding the marketing of the franchisor's service and/or product to their mutual benefit. While sub-objectives of the franchisor and the franchisee may be at variance, it is the job of the parent firm to bring about cooperation. Most franchisees are willing to operate in this environment of cooperation.

To this end, most franchised fast food service operations rely on distinctiveness of design of the outlet and highly standardized methods of food preparation and service to attract and serve their primary customers, the motoring public. Typical contract provisions include stated initial and working capital requirements, often financed in part by the franchisor, initial and continuing franchise fees or royalties to be paid to the franchisor in return for the privilege of doing business under his name and for services he provides to the franchisee, a territory protection clause, performance controls and provisions for termination or transfer of the franchise. In the case of transfer, the franchisor usually contractually reserves the right to approve a prospective buyer. In return for his initial and continuing payments to the franchisor, the franchisee is likely to receive a number of services in addition to the name and image of the franchisor. These typically include training at the franchisor's home office or at a company-owned outlet, a basic accounting system, possibly including

franchisor-prepared accounting records and tax returns, periodic assistance and inspection visits and participation in franchisor-sponsored advertising campaigns. These services are in addition to those tasks faced by independent businessmen in establishing their outlets which are largely provided to franchisees, services such as market research, interior decorating consultation and menu selection.

Many of the advantages of the franchise system to the franchisee are largely self-evident from the discussion of the typical franchise. They can be further summarized, however, into six categories. First, and of primary significance in this study is the often mentioned advantage of management guidance which is offered the franchisee as a result of his relationship with the franchisor. Second, and also basic, is the possibility of greater stability and survival of the franchisee in contrast to the potential for success of his independent competitor. Although, as mentioned earlier, meaningful statistical evidence in support of this advantage is scarce, the existing evidence does support it, and proof to the contrary is non-existent, particularly on an industry-wide basis. The third category relates to initial advantage gained through identity of the franchisee with the good reputation of the franchisor, clearly the case in the great majority of instances, while the fourth is the greater degree of independence that the

position of franchisee affords over that of being an employee. Fifth, the franchise system, by promoting high standards, has the potential of assisting the franchisee in the attainment of the service objective. Lastly, the franchisor-provided physical and administrative services allow the franchisee to concentrate his efforts on the operational and profit-making aspects of his business.

The limitations and disadvantages in franchising, while not nearly as self-evident as the advantages, can nevertheless be surfaced and categorized. The most widely publicized area of concern is that of misrepresentation and fraud, specifically in franchisee recruitment. Testimony before the Select Committee on Small Business, United States Senate, of 612 cases of franchise fraud occasioning the loss of over $27 million to investors in a five-year period is evidence of this problem. A second limitation sometimes encountered by the franchisee results from restrictions and limitations placed on his actions by the franchisor, limiting his discretionary actions and his flexibility to use his own ideas and his adaptability in a changing local situation. In the extreme, the franchisor may be able to dictate policies or procedures injurious to the individual franchisee but not to others in the chain, for the sake of invoking the principle of the greatest good for the greatest number.

A third concern for the franchisee is the question of legal aspects of franchising. Within this category, the question of contract termination provisions in the franchisor-franchisee agreement has been paid the most attention. Generally specified by the franchisor in the contract, the provisions in some cases place the franchisee in a position of being subject to an implicit threat of cancellation by the franchisor if certain conditions are not met. Extensive review of this area by agencies and bodies of the Executive and Legislative Branches of government, as well as by the courts, has provided some relief to automobile dealers and has fostered several recent attempts to protect franchisees of other types. Another legal facet of franchising, the basic questions of the legality of limiting the number of firms a franchisor sells to and of restricting the franchisees in their operations, has been the subject of anti-trust studies. Recent favorable pronouncements on the part of various governmental departments has served to dampen criticism on this point and to support the service sponsor-retailer type franchise as a worthwhile way of doing business.

Finally, of concern to the franchisee is the selection of new franchisees to add to an already successful system. Unlike the independent whose business reputation is his and his alone to enhance or destroy, the franchisee may suffer business losses attributable to the failures of his fellow

franchisees. Poor service at one outlet of the chain may deter customers from others. The franchisor, of course, may install controls to minimize this problem, but it is of real concern to the outstanding franchisee in his selection of a service or product line and in his continuing relationship with the parent company.

Franchisees contacted in the study all indicated that they felt their franchise arrangement afforded them advantages that they could not otherwise get. In addition to the advantage of having the established name and reputation of the franchisor and a distinctive building and equipment package, they most often mentioned the advantages of franchisor furnished management and operating assistance and franchisor furnished accounting systems. While nearly two-thirds of them felt there were shortcomings in their franchise relationship, primarily less than expected assistance by the franchisor and too restrictive franchise contracts, all of the franchisees contacted indicated that the advantages far outweighed the disadvantages.

The future potential for the fast food franchise industry appears bright, both for the franchisor and the franchisee. Franchisors have made some rather optimistic estimates of growth, as summarized in Table 1. While these predictions may not in all cases materialize, it is clear that the willingness of the consumer to spend a greater

portion of his rising disposable income on eating away from home coupled with increased automobile ownership in connection with the movement to suburbia paint a favorable picture for further growth of franchising. There is little question that federal and state controls of franchisors will be tightened in the near future and that there will be organized attempts within the industry to clean house and improve its image. These actions will in the long run, further enhance the chances of success of the franchisee, as will the improvements in franchisor furnished management and operating systems which evolve through experience and technological change.

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